ADP EXPLANATION FOR PUBLIC SCHOOLS WITH 403(b) PLANS

Why Refer to a 401(k) plan?

- The enclosed letter you received concerning universal availability failures in 403(b) plans provides a correction method that utilizes the Average Deferral Percentage (ADP) test.
- The ADP test is utilized by 401(k) plans to ensure that contributions made under those plans are nondiscriminatory between highly compensated employees and nonhighly compensated employees. This test compares the average deferral rates of highly compensated and nonhighly compensated employees. The ADP test is not used to test discrimination in 403(b) plans; however, the use of an average deferral rate can be a convenient way to approximate the amount of deferrals an employee might have made to the plan if he or she had been offered the opportunity to defer compensation into the plan.
- The ADP test is defined in section 401(k) of the Internal Revenue Code and 1.401(k)-1 of the Regulations.
- For additional information concerning section 403(b) plans, refer to Publication 4483, 403(b) Tax-Sheltered Annuity Plan for Sponsor, included in the original mailing.

What is a 401(k) plan?

- A qualified plan that allows employees to elect between receiving compensation or a contribution to a plan deferring its receipt (deferrals).
- Permits deferrals similarly to 403(b) plans, but is not a 403(b) plan.
- Contributions are subject to certain limits - for example: 402(g); non-discrimination testing (ADP Test).

Restrictions applicable to elective contributions

- Must be nonforfeitable.
- Must be nondiscriminatory.

Rules for Nondiscrimination Testing

- Elective contributions on behalf of Highly Compensated Employees (HCEs) must satisfy the ADP. The ADP test imposes a limit on the amount benefits provided under the plan to Highly Compensated Employees (HCEs) may exceed the benefits provided to Nonhighly Compensated Employees (NHCEs).
- Under the ADP test, the average salary deferrals of the HCEs and NHCEs are calculated and compared on an annual basis.
- Each employee's deferral percentage is the percentage of compensation that has been deferred on a pre-tax basis. It is calculated by dividing the deferral by the amount of compensation received.
- The deferral percentages of the HCEs and NHCEs are then averaged to determine the ADP of each group.

HCE vs. NHCE – How Do I Determine the Difference?

For public schools, the term HCE means any employee who earned in excess of $80,000 (as adjusted yearly) for the year preceding the testing year. A top-paid group election is also available to include only those earning above $80,000 and are in the top 20% of employees when ranked from the employee earning the highest amount of compensation to the employee earning the lowest. See section 414(q) of the Internal Revenue Code for more information.

Example: Calculating the ADP

Employee	Compensation	Deferral	Deferral Ratio	ADP
A	$100,000	$6,500	6.50%	
B	$ 90,000	$4,000	4.44%	5.31%
C	$ 80,000	$4,000	5.00%	
D	$ 20,000	$ 0	0%	
E	$ 10,000	$ 0	0%	3.33%
F	$ 10,000	$1,000	10.00%	

A, B and C are HCEs. D, E and F are NHCEs. The Deferral Ratios are added together for each group and then the average for each group is determined. The sum of the Deferral Ratios for the HCE group is 15.94% (6.50% + 4.44% + 5.00%). The ADP for the HCE group equals 5.31% (15.94% divided by 3, the number of employees belonging to the HCE group). The sum of the Deferral Ratios for the NHCE group is 10.00% (0% + 0% + 10.00%). The ADP for the NHCE group equals 3.33% (10.00% divided by 3, the number of employees belonging to the NHCE group).

403(b) Plans Do Not Finish the ADP Test Calculations and Stop at This Point!

Additional ADP Test information is provided for your convenience.

ADP Test Calculations

- A plan satisfies the ADP test if either the 1.25 test **or** the 2% spread test is met.

1. The 1.25 test. This test is satisfied if the ADP of the HCE group for the plan year does not exceed 1.25 times the ADP for the NHCE group. For example, if the ADP of the NHC group is 4%, the ADP of the HCE group would be limited to 5% (1.25 multiplied by 4%).
2. The 2% spread test. This test is satisfied if the ADP of the HCE group is not more than 2 percentage points over the ADP of the NHCE group, **and** is not more than twice the ADP of the NHCE group. In other words, to arrive at the limit for the HCE group, add 2% to the NHCE group's percentage or double that percentage, whichever produces the **smaller** result.

- The greater result is the limit for the HCEs. Since, the plan needs to pass only one of these tests, the greater of the two results sets the limit for the ADP of the HCE group.
- ADP failures must be corrected to protect the qualified status of the arrangement and preserve the tax favored benefits. Refer to Revenue Procedure 2006-27 for additional information concerning correction.

Illustrations of 2% Spread Testing

1. The ADP of the NHCE group is 3%. The ADP of the HCE group is limited to 5% under this test because adding 2% to 3% produces a smaller result than doubling 3% (6%, 2 X 3%).
2. The ADP of the NHCE group is 1.5%. The ADP of the HCE group is limited to 3% under this test because doubling 1.5% produces a smaller result than adding 2% (3.5%, 2% + 1.5%).
3. The ADP of the NHCE group is 0% (e.g. none of the NHCEs made deferrals under the 401(k) arrangement). The ADP of the HCE group is limited to 0% under this test because doubling 0% is a smaller result than adding 2% (2%, 2% + 0%).

Example: Finish Calculating the ADP Test:

Under the ADP test, the employer must compare the ADP of the HCE group to that of the NHCE group to determine whether the 1.25 test or the 2% spread test is met. Using the data from the Example: Calculating the ADP from above:

- The 1.25 test. 3.33 x 1.25 = 4.16 Since 5.31 is greater than 4.16, the 1.25 test is not met.
- The 2% spread test. 3.33 x 2 = 6.66, 3.33 + 2 = 5.33, 5.33 is the lesser of the two. Since 5.31 is less than 5.33, the 2% spread test is met and the plan passes the ADP test.